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COMMERCE FOR 4431/MAC/WH/MCAMERON
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HQ SOUTHCOM ALSO FOR POLAD

E.O. 12958: N/A
TAGS: ECON EFIN SOCI VE
SUBJECT: AN ECONOMIC SNAPSHOT: THE CRACKS ARE SHOWING

SUMMARY

¶1. (SBU) Inflation continues to rise despite government efforts to talk it down, and the government's tools to drain liquidity are increasingly ineffective. Foreign exchange reserves have fallen by 33.5 percent this year. Government spending continues apace, with the BRV running a large, though manageable, fiscal deficit of almost USD 4 billion during the first two months of 2007. Shortages are becoming more common and foreign exchange controls and the continual threat of nationalizations have led to a drop in the bolivar's parallel market rate. The hodgepodge of retrograde economic policies are generating growing distortions that are becoming increasingly prominent.

INFLATION

¶2. (SBU) Official Inflation was 1.4 percent for the month of April, and 19.4 percent for the past 12 months (almost double what it was a year ago). This increase followed a 0.7 percent decrease in March, caused mainly by the government's decision to cut three percentage points from the Value Added Tax (IVA). While the BRV sticks by its annual inflation goal of 12 percent, most private analysts expect inflation to exceed 20 percent in 2007 (it was 17 percent in 2006), continuing Venezuela's ranking for the highest inflation in the hemisphere.

¶3. (SBU) Five sectors grew above the average percentage rate for the month, including health care (3.4), general goods and services (2.5), food and non-alcoholic beverages (2.5), alcoholic beverages and tobacco (1.9) and home furnishings (1.9). The cost of food and non-alcoholic beverages (the sector where Venezuela's D and E classes spend most of their income) has increased 31.9 percent in the last 12 months.

¶4. (SBU) Inflation in Venezuela is being driven by a variety of factors, including large increases in government spending, excess liquidity, increasing demand, and stringent currency controls that push importers to use the parallel market. While Chavez and senior BRV officials are seized with addressing inflation, realizing that it burdens their supporters in the lower rungs of Venezuela's economic ladder, they have done little to confront the causes. Price controls

have led to widespread shortages. A recent trip by Econoff to the local grocery store found shelves lacking staples such as chicken, meat, butter, milk, black beans, and eggs (septel). Threats to nationalize supermarkets and private health care clinics (the two sectors showing the highest increase in prices this year) have led to lower investment and more anxiety.

LIQUIDITY

¶5. (SBU) Venezuela's money supply grew by 66 percent in bolivar terms in 2006, and the excess liquidity is apparent in the system where credit is easy and sales of everything from cars to whiskey has skyrocketed. BRV attempts to rein in liquidity (through selling BCV certificates of deposit to local banks and issuing dollar-denominated bonds) have been unsuccessful. The recent USD 7.5 billion PDVSA bond issuance is a prime example of the failure of BRV monetary policy. By selling USD 7.5 billion worth of dollar-denominated bonds to local investors in bolivars, the BRV hoped to reduce liquidity as those investors gave up their bolivars for dollars. However, liquidity has fallen by less than one percent since the issuance. Many people purchased bonds on margin (borrowing a percentage of the cost and paying the bank back after selling the bond overseas) and thus did not drain their accounts to buy the bonds. The money supply was not affected because banks chose not to renew USD 6 billion of the USD 16.2 billion worth of BCV CDs that they already held. Thus, they took money that was already removed from the money supply to cover the bond purchases. In the words of business school professor Gustavo Garcia, "the BCV's short term debt in bolivars was exchanged for PDVSA's long term debt in dollars," hardly a sound business practice.

SPENDING

¶6. (SBU) According to recently released BCV figures, the government ran a budgetary fiscal deficit of USD 3.8 billion (a little over 2 percent of GDP) during the first two months of 2007, and spending increased 30 percent over the same period in 2006. At the same time, non-oil tax revenues increased and revenues from oil sales decreased in line with a lower price for the Venezuelan oil basket and reduced production of approximately 2.4 million barrels per day. This amount of deficit spending is manageable in the short run as the government can increase revenues by producing more oil, and can dip into FONDEN or other off-budget funds. The deficit does demonstrate, however, the BRV's continued desire to spend, spend, spend and implies that at some point it will not be able to maintain the spending increases of the past few years.

CURRENCY

¶7. (SBU) While the official exchange rate is Bs. 2150 to the dollar, the parallel rate is on the rise again. The parallel rate rose to Bs. 4,000 to the dollar following threats by Chavez to withdraw from the IMF and World Bank and to nationalize the banking sector. The PDVSA bond issuance had a short term effect on the rate, but it shows no signs of returning to its historical average of 20-25 percent above the official rate.

RESERVES

¶8. (SBU) As of May 8, Venezuela's foreign exchange reserves

had decreased by USD 12.5 billion since the beginning of 2007, to about 24.7 billion. This 33.5 percent decrease in four months poses a challenge for Venezuela's central bankers. This drop is due to a variety of factors, including: transfers to the National Development Fund (FONDEN) (USD 6 billion), Venezuela's implementation of OPEC cuts at the beginning of the year (USD 1.2 billion), an increase in Commission for the Administration of Foreign Exchange (CADIVI) approvals (USD 3.5 billion more than the first trimester of 2006), payments to U.S. companies for the "nationalizations" of CANTV and EDC (USD 2.6 billion including the CANTV dividends), the BRV's decision to allocate a portion of PDVSA tax payments in dollars to a special treasury account outside of the BCV's control, and capital flight.

¶9. (SBU) Since the revision of Venezuela's Central Bank Law in 2005, the BCV has set a target for its foreign exchange reserves such that they would cover 12 months of foreign reserve needs (including imports, debt servicing, and other ancillary government requirements). "Excess" reserves have been transferred to FONDEN for use in social and development projects as well as debt buybacks and the purchase of Argentine and Ecuadoran debt. When one deducts the BCV's gold holdings (USD 7.6 billion), IMF position (USD 485 million), and special drawing rights (less than USD 1 million), its operative international reserves fall to around USD 16.7 billion. Due to the massive amount of consumption in Venezuela, the USD 29 billion level is no longer adequate to cover 12 months of requirements and USD 16.7 billion probably would not cover 6 months of imports at current rates of consumption. In 2006, Venezuela imported over USD 32 billion in goods.

COMMENT

¶10. (SBU) Recent announcements by Chavez and various officials indicate they are in denial about the mounting problems in the Venezuelan economy. For them, inflation and shortages are caused by profit-seeking oligarchs and capitalist-hoarders seeking to upset their socialist harmony. Minister for People's Power of Development and Planning

Giordanni recently blamed Venezuela's high growth rate, noting that 10 percent annual growth was bound to cause inflation and allow for demand to outstrip supply (apparently he has not read much about China).

¶11. (SBU) Given the refusal to modify fiscal policy (read reduce spending) and the ineffectiveness of monetary policy (evidenced by the PDVSA bonds debacle and mounting parallel rate), it seems that the BRV has precious few options effectively to deal with the mounting distortions. Post expects the BRV to fall back on propaganda -- as has been the case with crime, poverty, and unemployment statistics -- simultaneously denying that problems exist, eliminating the methodology that allow people to measure the problem, and finding scapegoats for the problems that come to the surface.
WHITAKER